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UNCLAS SECTION 01 OF 03 THE HAGUE 001697

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E.O. 12356: N/A
TAGS: EFIN NL ECON EUN
SUBJECT: The Netherlands' EU Stability Pact Dilemma

REF: USEU Brussels 3255

¶1. This message was jointly drafted by Embassy The Hague (Econ-Schultz), USEU Brussels (Econ-Brown), and ConGen Frankfurt (Treasury-Wallar)

¶2. Summary. The Netherlands' proposed EU stability program to be considered by the Ecofin Council July 14-15 is based on outdated numbers and presents a more optimistic outlook than more current forecasts. Finance minister Gerrit Zalm will have to confront slow growth and a growing deficit over the next two years that risk breaching the EU Stability and Growth Pact, jeopardizing the EU's "close to balance" target for 2007, and spotlighting Zalm's reputation as the Council's hard man on fiscal deficits. Self-imposed EMU deficit targets agreed in the Dutch government's coalition accord commit the center-right coalition to take measures when these targets are breached. In view of rapidly deteriorating economic growth prospects, budget retrenchments needed to redress the deficit problem seem unavoidable unless the deficit targets in the coalition accord are abandoned. Finance Minister Gerrit Zalm held fast to his principles at the June Ecofin in objecting to lenient treatment for France under the Pact's excessive deficit procedure. He will find it difficult to be as tough on the dutch government budget performance if the Dutch economy hits the skids predicted by these current forecasts. End summary.

¶3. New forecasts conflict with the assumptions underlying the Netherlands' revised EU stability program, due to be considered by member state finance ministers at the July 14-15 Ecofin Council. The numbers threaten to confront Finance Minister Gerrit Zalm with a dilemma he never had to face during eight years of economic upturn: slow growth and a rapidly growing deficit.

¶4. The revised Netherlands' economic outlook for 2003-2004

	2003	2004
	(y/y percentage change)	
GDP	0	1.25
Consumption	0.5	1
Investment	-3.5	-0.5
Exports	0.5	5
Inflation	2.25	1.25
Unemployment	5.5	6.75
	(percent of GDP)	
EMU-Deficit	-1.9	-2.6

¶5. The Hague Economic Officers and Senior Economic Adviser discussed the Dutch program with European Commission and Dutch permrep officials June 19 in Brussels. The European Commission's assessment of the Dutch proposal, the final country report in the EU's annual stability/convergence program exercise, forecast improving growth and a falling deficit. It is based on assumptions of 0.75 per cent GDP growth in 2003 increasing to 2.5 percent in 2007, leading to a nominal general government deficit of 1.6 per cent of GDP in 2003, 1.7 percent of GDP in 2004, and a 0.5 percent "close to balance" deficit target for 2007.

¶6. However, Council consideration of the report has been delayed because of the Dutch May 2003 general elections and the following change in government. Not surprising, the growth assumptions on which it is based have been overtaken

by events. In the interim, a bleaker than expected outlook for a recovery of world trade growth has led to recent downward revisions of GDP growth forecasts varying from stagnation (official Bureau for Economic Policy Analysis (CPB) and major commercial banks) to a 0.4 percent fall in GDP in 2003 followed by 1.25 percent growth in 2004 (recent Netherlands Central Bank forecast). The leaked, but yet unconfirmed, CPB scenario predicts a drop in tax revenues to catapult the nominal deficit to 1.9 per cent (10 billion euros) in 2003 and to 2.6 per cent (13 billion euros) in ¶2004. As a result, the budget deficit in 2007 increases to 0.9 percent of GDP, well away from the EU's 0.5 percent "close to balance" target.

¶7. The growing deficit forecast could lead to two serious consequences by the end of 2004:

o A fiscal deficit only 0.4 percentage points below the 3 per cent ceiling mandated by the EU Stability and Growth Pact; and

o Exceeding the 2.5 per cent self-imposed EMU deficit ceiling contained in the recently-published Government Coalition Accord.

¶8. Zalm's options appear to be limited. He can:

o Let the deficit run its course, stick to the hefty 13.1 billion euro consolidation package announced in the Coalition Accord and avoid the negative effects on GDP growth of further spending cuts or tax increases; or

o Propose further measures (spending cuts and/or tax increases) to steer the deficit away from the government-accord and Stability Pact deficit ceilings and thus cause a drag on growth

¶9. Under the first option, the Netherlands risks joining Portugal, Germany and France in the Stability Pact's "sin bin", the excessive deficit procedure. This could dent Zalm's reputation among his fellow finance ministers as "Il Duro" (the tough one). If, on the other hand, economic recovery in 2004 would help steer the deficit back on course towards balance, Zalm would not have to react immediately. He would, however, be prepared for additional deficit reduction should economic recovery not take hold in the second half of 2003.

¶10. Under the second option, Zalm would have to propose cutting spending by another 0.1 percentage point of GDP (0.5 billion euro on top of the 13.1 billion euro consolidation package already agreed) in order to reduce the deficit in 2004 from 2.6 to the self-imposed 2.5 percent deficit target in the coalition accord. But should the coalition-government stick to its goal to reduce the deficit during the next four-year period by an accumulated 1.8 percent of GDP to reach the EU's close-to-balance criteria in 2007, Zalm would have to take extra measures to the tune of at least 4 billion euro (0.4 percent of GDP). This would risk putting a damper on public spending and investment, serving as a possible drag on economic recovery. Raising taxes to bring the budget towards balance does not seem an option at the moment. It would strike at the roots of one of the objectives in the coalition accord of reducing the general (tax) burden to help raise the Netherlands' long-term growth potential.

¶11. Dutch PM Jan-Peter Balkenende admitted June 28 that extra measures to keep the deficit increase at bay, should the bleaker economic outlook hold, are unavoidable. Balkenende remained vague about the magnitude or the nature of additional budget measures. Although the Dutch PM agreed that sticking to the coalition accord deficit reduction target would require draconian spending cuts, he did not want to speculate about the possibility of abandoning the target. Finance Minister Gerrit Zalm held fast to his principles at the June Ecofin in objecting to lenient treatment for France under the Pact's excessive deficit procedure (reftel). He will find it difficult to be as tough on the Dutch government's budget performance if the Dutch economy hits the skids predicted by these current forecasts.

¶12. Since additional cuts in spending are hard to find or are politically sensitive, pressure on labor unions to observe wage moderation, as an alternative means to cut spending, is likely to increase. Wage moderation is seen as having double benefits: reducing the wage bill in the public sector would narrow the deficit gap, and reducing it in the private sector would help to restore the seriously eroded Dutch competitive position. Whichever route the center-right coalition chooses to go to meet its EU and EMU budget commitments it is likely to create political unrest and affect business and consumer sentiment. Recent surveys show that public anxiety about the deterioration of public finances and opposition to the proposed spending cuts is

rapidly growing.

SOBEL